

PENSION SCHEMES AND PENSION FUNDS IN THE UNITED KINGDOM

CONTENTS

List of Abbreviations

xxiv

1. THE HISTORICAL DEVELOPMENT OF PENSIONS AND PENSION SCHEMES IN THE UNITED KINGDOM	1
1. The Development of State Pensions	3
1.1. State Pensions for Public Servants	3
1.2. State Pensions for Members of the Public	6
Appendix: The Welfare Reform and Pensions Act 1999	20
2. The Development of Occupational, Personal, and Stakeholder Pension Schemes	22
2.1. The Development of State Occupational Pension Schemes	22
2.1.1. Occupational Pension Schemes for Civil Servants	22
2.1.2. Occupational Pension Schemes for Local- government Officers	25
2.1.3. Occupational Pension Schemes for Other Public-sector Employees	26
2.2. The Development of Private Occupational Pension Schemes	28
2.3. The Development of Personal and Stakeholder Pension Schemes	32
3. The Role of the State in the Development of Pensions and Pension Schemes	35
3.1. The Purposes behind the State's Provision of Pensions	35
3.2. The State's Influence on the Development of Occupational, Personal, and Stakeholder Pension Schemes	36
3.2.1. Indirect Influences	36
3.2.2. Direct Influences	38
3.2.2.1. Tax Concessions	38
3.2.2.2. Cooperation between the State and Private Schemes	43
3.2.2.3. Legislative Controls and Concessions	44
3.2.2.3.1. The Rights of Early Leavers	44
3.2.2.3.2. Continuity of Pension Rights when the Contract of Employment Changes	46
3.2.2.3.3. The Disclosure of Information	46
3.2.2.3.4. The Equal Treatment of Men and Women	47
3.2.2.3.5. Disability Discrimination	49
3.2.2.3.6. Pension-fund Surpluses	50
3.2.2.3.7. Investor Protection	51
3.2.2.3.8. Income Drawdown	53
3.3. Conclusion	54
Selected Bibliography for Part I	55

II. PENSIONS AND PENSION SCHEMES IN THE UNITED KINGDOM	57
4. The Basic State Pension Scheme, the Minimum Income Guarantee, and the Pension Credit	59
4.1. Entitlement to the Basic State Pension	59
4.2. Types of Basic State Pension	63
4.2.1. The Category A Pension	63
4.2.2. The Category B Pension	63
4.2.3. The Category C and D Pensions and the Age Addition	64
4.3. Incapacity Benefit and Bereavement Benefit	65
4.4. Duty of Care in Providing Information to Potential Pensions Claimants and the DWP Compensation Scheme	66
4.5. Pension Rights in Hospital or on Holidays Abroad	67
4.6. Pension Rights of British Pensioners Resident Overseas	68
4.7. Pension Rights Earned Overseas	69
4.8. War Pensions	70
4.9. The Taxation of Pensions	71
4.9.1. Pensions Received in the UK	71
4.9.2. Pensions Received from Overseas	72
4.10. The Minimum Income Guarantee and the Pension Credit	74
5. The State Second Pension Scheme and its Predecessors	79
5.1. The State Second Pension Scheme	79
5.1.1. S2P 2002-7	80
5.1.1.1. The Entitlement to the S2P	80
5.1.1.2. Calculating the S2P	82
5.1.1.3. The Contracted-out Rebates	83
5.1.2. S2P from 2007	84
5.1.3. Inherited SERPS	84
5.2. The State Earnings-related Pension Scheme	85
5.2.1. SERPS 1978-88	85
5.2.1.1. The Entitlement to a SERPS Pension	85
5.2.1.2. Calculating the SERPS Pension	85
5.2.2. SERPS 1988-99	87
5.2.2.1. The Proposed Changes to SERPS	87
5.2.2.2. The Actual Changes to SERPS	90
5.2.3. SERPS 2000-2	92
5.3. The State Graduated Retirement Pension Scheme	92
6. Occupational Pension Schemes	94
6.1. The Legal Structure of and Regulatory Framework for Occupational Pension Schemes	94
6.1.1. The Trust Fund	94
6.1.2. Trustees	95
6.1.3. The Occupational Pensions Regulatory Authority	103
6.1.4. Minimum Funding Requirement and Scheme-specific Funding Standard	105
6.1.4.1. The Minimum Funding Requirement	105
6.1.4.2. Problems with the Minimum Funding Requirement	106

6.1.4.2.1. The MFR did not Guarantee that the Pension will be Paid in Full	106
6.1.4.2.2. The MFR was Highly Sensitive to Changes in Market Value Adjustments	107
6.1.4.2.3. The MFR and Statutory Valuations were not Consistent with Each Other	108
6.1.4.2.4. The MFR Restricted Pension Funds from Investing in an Optimal Mix of Assets	109
6.1.4.2.5. Many of the Assumptions Underlying the MFR were Either Out of Date or Inaccurate	110
6.1.4.3. The MFR Review	110
6.1.4.3.1. Key Recommendations	110
6.1.4.3.2. Government Consultation	111
6.1.4.4. A Scheme Specific Funding Standard	112
6.1.5. Winding up a Pension Scheme	113
6.2. Inland Revenue Approval	116
6.2.1. Exempt Approved Schemes	116
6.2.2. Limits on Contributions	117
6.2.3. Limits on Pensions	118
6.2.4. Taxation Issues	122
6.2.4.1. Income and Capital-gains Taxes	122
6.2.4.2. Inheritance Tax	123
6.2.5. Unapproved Schemes	123
6.3. Types of Schemes and Eligibility for Membership	125
6.3.1. Contracted-out and Non-contracted-out Schemes	125
6.3.1.1. What is Contracting Out?	125
6.3.1.2. Contracted-out Salary-related Schemes	126
6.3.1.3. Re-contracting into the State Scheme	129
6.3.1.4. Contracted-out Money Purchase and Mixed Benefits Pension Schemes	129
6.3.1.5. Group Money Purchase Pension Schemes	132
6.3.2. Private-sector and Public-sector Schemes	132
6.3.3. The Eligibility for Membership of Occupational Pension Schemes	138
6.4. The Rights of 'Pension-scheme Members	142
6.4.1. The Rights of Existing Members	142
6.4.1.1. The Participation Rights of Members	142
6.4.1.2. The Right to Consultation and to Receive Information	143
6.4.1.3. The Safeguarding of Acquired Rights	144
6.4.1.4. The Rights when there is a Change of Employer	144
6.4.2. The Rights of Members who Leave Schemes when Changing Employment	144
6.4.2.1. Return of Contributions	145
6.4.2.2. Preserved Pension	145
6.4.2.3. Transfer to a Contracted-in Scheme	147
6.4.2.4. Transfer to a Contracted-out Scheme	147
6.4.2.5. Transfer to a Section 32 Buy-out Policy	148
6.4.2.6. Transfer to a Personal or Stakeholder Pension Scheme or an Annuity	149
6.4.2.7. Transfers to an Overseas Pension Arrangement	149
6.4.2.8. Transfer Values where the Pension is in Payment	150

6.4.2.9. The Determination of the Size of the Transfer Value	151
6.4.3. The Rights of Members who Leave Schemes Involuntarily	155
6.4.4. The Protection of Pension Rights	155
6.5. Contributions	159
6.5.1. Types of Contributions	159
6.5.1.1. Principal Contributions	159
6.5.1.2. Additional Voluntary Contributions and Free-standing Additional Voluntary Contributions	159
6.5.2. Standard Contribution Rates	163
6.5.3. The Civil Servants' Scheme	165
6.6. Types of Retirement Benefit	167
6.6.1. Normal Retirement Benefits	167
6.6.1.1. Normal Retirement Age	167
6.6.1.2. Pensionable Salary	167
6.6.1.3. Pension Formula	169
6.6.1.4. Commutation Rights	171
6.6.2. Early- and Late-retirement Benefits	172
6.6.2.1. Early-retirement Benefits	172
6.6.2.2. Late-retirement Benefits	173
6.6.3. Death Benefits	174
6.6.3.1. Lump-sum Death-ill-service Benefits	174
6.6.3.2. Widows' and Widowers' Pensions on Death-in-service	175
6.6.3.3. Dependent Children's Benefits on Death-in-service	176
6.6.3.4. Post-retirement Death Benefits	176
6.7. Indexation of Pensions against Inflation	176
6.7.1. The History of Pensions Indexation	177
6.7.2. Current Statutory Indexation Rules	180
6.7.3. Current Practice in Occupational Schemes	182
6.8. Summary	182
7. Personal and Stakeholder Pension Schemes	185
7.1. The Introduction of Personal Pension Schemes	185
7.1.1. Defined Benefit Versus Defined Contribution Schemes	185
7.1.2. The 1986 Social Security Act	186
7.2. The Legal Structure of Personal Pension Schemes	188
7.2.1. The Inland Revenue's Model Rules	188
7.2.2. Trustees	188
7.3. The Financial Structure of Personal Pension Schemes	189
7.3.1. Investment Vehicles for Personal Pension Schemes	189
7.3.1.1. Endowment Schemes	190
7.3.1.2. Unit-linked Schemes	191
7.3.1.3. Deposit Administration Schemes	192
7.3.2. Providers of Personal Pension Schemes	192
7.3.3. Categories of Assets for Personal Pension Schemes	193
7.3.4. Charges	193
7.3.5. Surrender, Maturity, Paid-up, and Transfer Values	196
7.3.6. Investor Protection	196
7.4. Types of Personal Pension Scheme	200
7.4.1. Appropriate Personal Pension Schemes	200

7.4.2. Rebate-only Personal Pension or Contracted-in Money Purchase-Schemes	201
7.4.3. Self-invested Personal Pension Schemes	202
7.4.4. Group Personal Pension Schemes	203
7.4.5. Industry-wide Portable Pension Schemes	205
7.4.6. Targeted Money-purchase Schemes	206
7.4.7. Section 32 Buy-out Policies	207
7.5. Contributions	207
7.5.1. Minimum Contributions	208
7.5.2. Maximum Contributions	211
7.5.3. Refunding Excess Contributions and (Until 2001) Carry-forward and Carry-back of Contributions	212
7.5.4. Self-employed Contributions	213
7.5.5. Delays in Reclaiming National-insurance Rebates and Paying Contributions on Time	213
7.5.5.1. Responsibilities of the National-insurance Contributions Office (NICO)	213
7.5.5.2. Responsibilities of the Employers and Providers	214
7.5.6. Pension Investment Protection Insurance	216
7.6. The Impact of Personal Pension Schemes	218
7.6.1. Sales of Personal Pension Schemes	218
7.6.2. No Savings to the State	220
7.7. The Introduction of Stakeholder Pension Schemes	221
7.8. The Legal Structure of Stakeholder Pension Schemes	222
7.8.1. Manner of Establishment and Scheme Governance	222
7.8.1.1. Trust-based Schemes	223
7.8.1.2. Contract-based Schemes	225
7.8.2. Regulation of Schemes	227
7.8.2.1. The Role of OPRA-To Ensure Proper Administration and Security	227
7.8.2.2. The Role of Employers-To Facilitate Access	228
7.8.2.3. The Role of the FSA-To Regulate Sales, Marketing, and Fund Management	229
7.8.2.4. Winding-up Regulations	230
7.8.2.5. Other Restrictions	230
7.9. The Financial Structure of Stakeholder Pension Schemes	231
7.9.1. Minimum Standards: Why are they Necessary?	231
7.9.2. Charges	231
7.9.3. Minimum Level of Contributions	234
7.9.4. Statement of Investment Principles, Permissible Investment Vehicles, and Investment Performance Comparisons	234
7.9.4.1. Statement of Investment Principles	234
7.9.4.2. Permissible Investment Vehicles	235
7.9.4.3. Investment Performance Comparisons	237
7.9.5. Advice and Information	237
7.9.5.1. Advice	237
7.9.5.2. Information	238
7.9.6. Transfers	239
7.1.0. The Impact of Stakeholder Pension Schemes	240
7.1.0.1. Sales of Stakeholder Pension Schemes and IPAs	240

7.1.0.2. The Internet and E-Pensions	241
7.11. Normal Retirement Benefits	242
7.11.1. Annuity Pensions	242
7.11.1.1. Types of Annuity Pensions	244
7.1.1.1.2. Open-market Option	252
7.11.2. Lump Sum	253
7.12. Early- and Post-retirement Benefits	254
7.12.1. Early-retirement Benefits	254
7.12.1.1. Voluntary Early Retirement	254
7.12.1.2. Early Retirement due to ill Health	255
7.12.2. Post-retirement Benefits	255
7.13. Preserved Benefits	256
7.14. Taxation Issues with Personal and Stakeholder Pensions	257
7.14.1. Tax Treatment of Personal Pensions Between 1988 and 2001	257
7.14.2. Tax Treatment of Defined Contribution Pensions since 2001	258
7.15. Concurrency between Personal, Stakeholder, and Occupational Pension Schemes	261
7.16. Indexation of Pensions Against Inflation	262
7.16.1. Indexation of Preserved Benefits	262
7.16.2. Indexation of Pensions in Payment	262
7.17. Risks Associated with Defined Contribution Pension Schemes	263
7.17.1. General Risks	263
7.17.2. Additional Risks with Unit-linked Schemes	267
7.18. Summary	267
8. Self-employed, Partners', Executives', and Directors' Pension Schemes	270
8.1. Self-employed and Partners' Pension Schemes	270
8.2. Executive Pension Schemes	270
8.3. Directors' Pension Schemes	274
8.3.1. Pension Schemes for Individual Directors	274
8.3.2. Special Rules for 20 per cent Directors	275
8.3.3. Small Self-administered Pension Schemes	275
8.3.4. Self-administered Pension Schemes for Controlling Directors	277
8.3.5. Friendly-society Pension Schemes	278
9. Pension Choices and Retirement Decisions	279
9.1. Pension Choices	279
9.1.1. The Choice between <i>S2P</i> and an Occupational Pension Scheme	281
9.1.2. The Choice between <i>S2P</i> and a Personal/Stakeholder Pension Scheme	282
9.1.3. The Choice between an Occupational Final-salary Pension Scheme and a Personal/Stakeholder Pension Scheme	284
9.1.4. The Choice between a Personal Pension Scheme and a Contracted-out Money Purchase Scheme	287

9.1.5. The Choice between Company Money Purchase Schemes	289
9.1.6. The Choice between a Personal Pension Scheme, a Stakeholder Pension Scheme and a Group Personal Pension Scheme	290
9.1.7. The Choice between a Stakeholder Pension Scheme and Additional Voluntary Contributions	290
9.1.8. The Choice between Additional Voluntary Contributions to a Pension Scheme and Independent Savings Accounts	292
9.1.9. The Non-pension Benefits of Pension Schemes	293
9.1.9.1. Pension Mortgages	293
9.1.9.2. Pension Loans	295
9.1.10. Pension Unlocking and Pension Liberation	297
9.2. Retirement Decisions	298
9.2.1. Deciding the Age of Retirement	298
9.2.2. Using the Lump Sum to Buy an Annuity	299
9.2.3. Other Sources of Income in Retirement	300
9.2.3.1. Part-time Employment	300
9.2.3.2. Equity Release	301
9.2.3.3. Individual Savings Accounts	302
9.2.3.4. National Savings Pensioners Guaranteed Income Bonds	303
9.2.4. Pension Deferral	303
9.2.5. Retirement Planning and the Retirement Trap	304
9.2.6. The Cost of Long-term Care in Old Age	305
1.0. Pensions and Public Policy	308
10.1. Government Policy since 1979	308
10.1.1. The Thatcher-Major Reforms to the Pension System	308
10.1.2. Defects in the Thatcher-Major Reforms	311
10.1.3. The Blair Reforms to the Pension System	312
10.1.3.1. The Department of Social Security Proposals	312
10.1.3.1.1. State Pensions	313
10.1.3.1.2. Stakeholder Pensions	314
10.1.3.1.3. Occupational Pensions	315
10.1.3.1.4. Personal Pensions	315
10.1.3.2. HM Treasury Proposals	315
10.1.4. Assessment of the Blair Reforms	315
10.1.4.1. Reforms to State Pensions	316
10.1.4.2. Reforms to Private Pensions	318
10.1.5. The Pickering and Sandler Reports	319
10.1.5.1. The Pickering Report	319
10.1.5.2. The Sandler Report	324
10.1.6. The Political Economy of Pension Reform	328
10.2. Other Public-policy Issues	329
10.2.1. The Battle between the Generations	330
10.2.1.1. What is the Potential for Inter-generational Conflict?	330
10.2.1.2. How Secure is a Pension Fund Really?	331
10.2.2. The Battle with the State over Taxation	333
10.2.2.1. Would it be Better to End Tax Relief on Pension Schemes?	333
10.2.2.2. Personal Pensions: Too Successful for their Own Good?	334

10.2.3. The Battle between the Members and the Sponsor	334
10.2.3.1. Who Owns the Pension-fund Assets?	334
10.2.3.2. Who Owns the Pension-fund Surpluses and Deficits?	335
10.2.3.3. How Independent are Pension Fund Trustees?	338
10.2.3.4. The Right to Know?	339
10.2.3.5. How Visible Should Pension-fund Assets and Liabilities Be?	339
10.2.3.6. What about Theft by the Sponsor?	340
10.2.4. The Battle of the Sexes	357
10.2.4.1. Equal Treatment	357
10.2.4.2. Pensions and Divorce	362
10.2.5. The Battle with Creditors	363
10.2.6. The Battle with the Markets	364
10.2.7. The Battle over Charges	364
10.2.8. The Battle over Product and Service Standards	366
10.2.9. The Battle over the Adequacy of Contributions into Private-sector Pension Schemes	366
10.2.10. The Battle over the Future of Final Salary Schemes	369
Selected Bibliography for Part II	371
III PENSION FUNDS IN THE UNITED KINGDOM	375
11. Pension Funding in the United Kingdom	377
11.1. What is Pension Funding?	377
11.2. Types of Pension Fund	380
11.2.1. Provident and Pooled Funds	380
11.2.2. Internal and External Funds	381
11.2.3. Insured and Self-insured Funds	383
11.3. Funding in the Public and Private Sectors	383
11.4. The Accounting Framework for Pension Funds	385
11.5. Pension-fund Deficits and Surpluses	393
11.5.1. Estimating the Deficits and Surpluses	393
11.5.2. The 1986 Finance Act	395
11.6. The Income-and-Expenditure Accounts of UK Pension Schemes	399
12. Pension-fund Investments	400
12.1. The Regulatory Environment	400
12.1.1. The Statutory Framework	400
12.1.2. Self-regulation	404
12.1.3. The Megarry Judgment	404
12.1.4. The European Union Pension Fund Directive	405
12.2. The Investment Environment	407
12.2.1. Long-term Stability	407
12.2.2. Predictable Change	408
12.2.3. Short-term Volatility	409
12.2.4. The Euro	412
12.3. The Components of a Pension-fund Portfolio	413
12.3.1. Money-market Securities	413

12.3.2. Bonds and Loans	415
12.3.3. Shares	418
12.3.4. Collective Investment Vehicles	419
12.3.4.1. Unit Trusts and Open-ended Investment Vehicles	419
12.3.4.2. Investment Trusts	420
12.3.4.3. Insurance Products	421
12.3.4.4. Exchange-traded Funds and Guaranteed Growth Funds	422
12.3.5. Real Assets	423
12.3.5.1. Property	423
12.3.5.2. Land	425
12.3.5.3. Collectibles	425
12.3.6. Derivatives	426
12.3.6.1. Forwards and Futures	426
12.3.6.2. Options, Warrants, and Convertibles	428
12.3.6.3. Swaps	428
12.3.6.4. Forward-rate Agreements	431
12.3.7. Alternative Investments	431
12.3.7.1. Public Market Strategies	432
12.3.7.2. Private Market or Private Equity Strategies	437
12.3.7.3. Natural Resources	439
12.3.8. Socially Responsible Investment	440
12.3.9. Global Custody	441
12.4. Different Asset Characteristics and Uses	442
12.4.1. Asset Characteristics	442
12.4.2. Asset Uses	443
12.5. UK Pension Funds and their Asset Holdings	451
12.5.1. The Leading Pension Funds in the UK	459
13. Pension-fund Management	466
13.1. The Functions of Pension-fund Management	466
13.2. Fund-management Styles	467
13.3. Asset-Liability Modelling and Management	470
13.4. Different Fund-management Strategies for Defined Benefit and Defined Contribution Schemes	472
13.5. Dealing with the Trustees	473
13.5.1. Determining the Trustees' Objectives and Constraints	473
13.5.2. The Optimal Portfolio	476
13.5.3. Investment Risk Budgeting	479
13.6. Passive Fund Management	480
13.6.1. Passive Fund Management for Expected Utility Maximizing Trustee	484
13.6.2. Passive Fund Management for Safety-first Trustees	484
13.7. Active Fund Management	490
13.7.1. Active Share-fund Management	490
13.7.2. Active Bond-fund Management	494
13.8. Mixed Active-Passive Fund Management	499
13.9. Performance Measurement	500

13.9.1 <i>Ex-post</i> Returns	500
13.9.2. Adjusting for Risk	503
13.9.3. Benchmarks of Comparison	503
13.10. Measures of Portfolio Performance	505
13.10.1. Performance Measures Based on Risk-adjusted Excess Returns	505
13.10.2. Performance Measures Based on Alpha	508
13.11. Performance Attribution	509
13.12. Liability-driven Performance Attribution	513
13.13. Hedging and Efficient Portfolio Management	516
13.13.1. The Objective of Hedging	517
13.13.2. Hedging with Futures	517
13.13.2.1. Hedging with Stock-index Futures	519
13.13.2.2. Hedging with Bond Futures	520
13.13.2.3. Hedging with Currency Futures	523
13.13.3. Hedging with Options	524
13.13.3.1. Hedging with Individual Stock Options	524
13.13.3.2. Hedging with Stock-Index Options	529
13.13.3.3. Hedging with Bond Options	530
13.13.3.4. Hedging with Currency Options	530
13.13.4. Hedging with Swaps	531
13.13.5. Efficient Portfolio Management	532
13.14. Pension-fund Managers	533
13.14.1. The Leading Pension-fund Management Groups	533
13.14.2. Selecting the Fund Manager	535
13.14.3. Firing the Fund Manager: The Case of Unilever and Mercury Asset Management	538
13.14.4. Charges for Fund Management	547
13.14.5. Fund-management Information-and-analysis Service	549
13.14.5.1. Statistical Services	551
13.14.5.2. Research-and-analysis Services	552
13.15. Pension-fund Consultants	552
Appendix: Investment-objectives Questionnaire	553
14. Pension-fund Investment Performance	557
14.1. The Investment Performance of Occupational Pension Funds	557
14.2. The Investment Performance of Personal Pension Schemes	564
14.3. Some Problems with Performance Measurement and Presentation	566
14.3.1. How to Measure Investment Performance	567
14.3.2. Methods of Comparison	568
14.3.3. Selection Bias and Survivor Bias	569
14.3.4. Performance Presentation Standards	570
15. The Consequences of Pension Funds for Capital Markets	574
15.1. The Good Consequences of Pension Funds	574
15.1.1. Helping to Make Capital Markets Efficient	574

15.1.2. Providing a Large, Loyal Shareholder Base for Financing Real Investment	575
15.2. The Bad Consequences of Pension Funds	576
15.2.1. Ignoring Long-term Investment Opportunities	576
15.2.2. Hostile Takeover Bids	578
15.2.3. The Issue of Pre-emption Rights	580
15.2.4. The Dangers of Fraud and Malpractice	581
15.2.5. The Consequences of Reducing Pension-fund Surpluses and the Increasing Maturity of Pension Funds	582
15.2.6. Inadequate Supply of Matching Assets	583
15.2.7. Poor Relationships between Trustees and Investment Managers	584
15.2.8. Solving the Problem?	586
15.3. The Myners Review of Institutional Investment	588

Selected Bibliography for Part III

IV. POSTSCRIPT

16. The Ideal Pension Scheme	601
16.1. The Pension Problem in a Nutshell	601
16.2. What is Wrong with Existing Arrangements?	602
16.2.1. What is Wrong with PAYG?	602
16.2.2. What is Wrong with Occupational Schemes?	603
16.3. How can we Improve on Existing Arrangements?	604
16.4. The Ideal Pension Scheme	606

Selected Bibliography for Part IV 611

<i>Stop Press: Summary of Two Government Green Papers Published in December 2002</i>	613
<i>Appendix: Pensions-related Organizations</i>	622
<i>Glossary</i>	629
<i>Index</i>	707